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WEEKEND JOURNAL

Prosecutor of Kerviel seeks 4-year prison term

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## World champions out of the Cup



Christian Maggio, left, and Fabio Cannavaro are despondent as champions Italy exited the World Cup after a 3-2 defeat against Slovakia. Article on page 28; match reports at [WSJ.com/WorldCup](http://WSJ.com/WorldCup)

## Skilling, Black score big win in U.S. court

By JESS BRAVIN AND BRENT KENDALL

WASHINGTON—The Supreme Court dealt a blow Thursday to the convictions of Enron's Jeffrey Skilling and former media mogul Conrad Black, issuing a trio of unanimous opinions that eviscerated a favorite prosecution tool against corporate and public corruption.

Writing for the court, Justice Ruth Bader Ginsburg said prosecutors pushed too far in using a federal law that makes it a crime for a person to deprive others of his "honest services." Justice Ginsburg said prosecutors used it as a catch-all charge against allegedly corrupt behavior instead of sticking to the more precisely defined offenses of bribery and kickback schemes.

That practice violates the Fifth Amendment guarantee that "no person shall be...deprived of life, liberty or property, without due process of law," the court found. Due process requires that people know clearly where the line is

drawn between criminal and lawful behavior, the court has held.

Mr. Skilling was alleged to have pumped up Enron Corp.'s share price by misleading the public about the company's health, even as it careered toward bankruptcy. Because his own compensation, plus his own portfolio's value, was tied to Enron's share price, Mr. Skilling deprived shareholders of "the intangible right of honest services," as the statute puts it, prosecutors alleged.

Applying her logic that only clearly defined offenses such as taking kickbacks or bribes can be punished under the statute, Justice Ginsburg wrote that Mr. Skilling "did not commit honest-services fraud." She said the same in a separate case involving Lord Black. The court also ruled in favor of a former Alaska state legislator, Bruce Weyhrauch, snared in a corruption probe.

The ruling does not mean Mr. Skilling, sentenced in 2006 to 24 years imprisonment, necessarily goes free.

The case will return to lower courts to address issues the decision implicates, including Mr. Skilling's related conviction for conspiracy.

Nonetheless, it is a sharp setback for the Justice Department, one that calls into question many convictions previously won under the honest-services law.

"I do not think anyone walks immediately, but there will be lots of complicated lower-court litigation" over whether convictions can stand, said criminal law specialist Douglas Berman, a law professor at Ohio State University. Mr. Berman said parties are also likely to battle over "whether the government can keep convictions and sentences in place while this litigation unfolds."

At a judicial conference last month, Solicitor General Elena Kagan, whose office represents the government before the Supreme Court, stressed the importance of the honest-services cases to federal prosecutors.

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## Cameron takes skepticism to G-20

By ALISTAIR MACDONALD

HALIFAX, Nova Scotia—New U.K. Prime Minister David Cameron, making his debut on the global stage at this week's meetings of international leaders in Toronto, is striking a skeptical tone about the ability of leaders to carry out their lofty conference promises.

Mr. Cameron, in office for just six weeks, has emphasized domestic policy over foreign affairs during most of his political career. Arriving in Canada on Thursday for meetings of the Group of 20 and Group of Eight economies, he took a low-key approach to the possible output of the sessions. He emphasized the potential for simple bilateral agreements with individual

nations over the kind of broad, unified reform that such sessions typically aim to achieve.

In that way, he is striking a much different stance than his predecessor, Gordon Brown, who relished the role of statesman and used such meetings to push for sweeping action, such as pushing hard for the Doha global trade deal that Mr. Cameron says is unlikely to be sealed this weekend. Mr. Cameron, in his short time as prime minister, has shown himself as pragmatic rather than ideological on foreign policy, particularly in his Conservative Party's prickly dealings with the European Union. He has advocated pragmatic engagement rather than grandstanding rhetoric.

In an opinion piece to be



Prime Minister Cameron boards a Canada-bound plane Thursday.

published Friday by the Canadian newspaper the Globe and Mail, Mr. Cameron writes that the intentions of such global forums "rarely seem to come to fruition in real, tangible global action." Mr. Cameron adds that he hopes to pursue

"immediate and relatively simple steps" that can be achieved through bilateral deals with countries, such as on trade. He adds that the U.K.'s main priority is to hear each country getting their "national finances under con-

trol."

This week, for example, Britain set out an aggressive plan of spending cuts and tax increases to rein in its deficit, one of the largest in the world. Its deficit-cutting approach comes against the advice of President Barack Obama and others attending the G-20 who say it risks undercutting the global economic recovery.

Speaking to reporters en route to Toronto, Mr. Cameron said the G-20 has "shown it has a role on the global economy." Nonetheless, he was critical of the inability of such

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Peacock is an acquired taste that some in California don't share. Page 29

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Olli Rehn: Budget cuts won't hurt the recovery. Page 13

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## PAGE TWO

# Give politicians performance bonuses

## [ Agenda ]

BY THEO VERMAELEN

During the financial crisis, politicians across the spectrum have assailed banker's bonuses. In a similar way, politicians should now use the sovereign-debt crisis as an opportunity to re-examine their own pay. The collapse of the largest Ponzi scheme in history, the European Social Model, is not caused by inappropriate bonuses, but by a lack of bonuses.

Politicians, as all government bureaucrats, get a fixed salary which means that they bear no financial consequences of their decisions. The result is that politics attracts people driven by power and prestige, or occasionally by a sense of duty for their country. Moreover, there is also no board of directors that can fire "top management" if it underperforms. The voters are stuck with the people they voted for until the next election.

The result of this poor governance mechanism is that it encourages fiscal irresponsibility. In order to be elected, a politician has to buy votes with borrowed money. The cost of this excessive borrowing and spending is shifted to future generations, our children. Because our children don't vote, this process is not truly democratic. It also explains why markets don't believe that politicians will respect the Maastricht criteria, which try to reduce government spending and borrowing. Especially, as the governance mechanism of the European Union is based on punishing countries, not individual politicians. Collective punishment has never been a good instrument to motivate individual responsibility.

One way to improve governance within the European Union is to introduce the necessary financial carrots and sticks to make politicians behave more responsibly. This does not mean that being fiscally irresponsible will not be allowed,



Martine Aubry speaks last week against plans to raise France's retirement age.

but it will come with a price. The fact that a price will have to be paid will make electoral promises of fiscal irresponsibility less credible and therefore less attractive. For example, Martine Aubry, leader of the French Socialist party has said that she will undo all anti-social measures (such as increasing the retirement age) proposed by President Nicolas Sarkozy if she is elected. If the electorate knows that Mrs. Aubry and her socialist friends would have to pay a significant personal cost if they live up to their promises, it becomes less likely that the electorate will believe these promises.

In order to change politicians' behavior, the bonuses in case of good performance will have to be substantial. This may pose a problem as the electorate would interpret any bonus scheme as a way for politicians to grab more taxpayers' money. The scheme, therefore, has to be imposed on all members of national parliaments by European law. The law would stipulate that in order to be able to stay in the European Monetary Union, all elected politicians have to accept to be paid in function of measures tied to the Maastricht criteria and other more refined measures of fiscal responsibility.

A more refined measure would include for example the salaries of government employees. If these employees cannot be fired and are

replaced after retirement with new ones, their salaries are equivalent to perpetual government debt. This debt can be substantial. For example, France spends at least €100 billion (\$122.7 billion) per year on salaries to government employees. If these salaries grow at say 2% per year and are discounted at an interest rate of 5% per year, it can be shown that the present value of such a commitment is more than €3 trillion, which is three times as large as the financial debt used to calculate compliance with the Maastricht criteria. If such a measure were tied to politicians' compensation, they would have a large incentive to reduce the number of government employees and/or privatize government services.

One critique against such a scheme is that politicians will now be motivated by greed, not by power and power may not be a worse motivator than greed. The difference, however, is that under my proposal, greed will encourage cutting government expenditure, while power encourages government expenditure. So, for ensuring financial stability greed works better than power.

A second critique is that it may encourage short-term gaming: A politician could reduce the deficit by increasing taxes this year, but the economic damage will increase the deficit in the future. One solution would be that a

bonus has to be "banked" and can only be paid out several years after the politician has left office. An alternative solution would be to pay higher bonuses if the budget gets balanced by cutting government expenditures rather than by increasing taxes.

A final problem is that wealthy people would care less about the money they make as politicians. Moreover, politicians can make extra money after leaving office by writing books and by giving speeches. Therefore I would propose that elected officials have to put up half of their personal wealth as collateral against debt issued during their time in power.

One of the side benefits of this scheme is that it reduces the moral hazard of banks that are considered too-big-to-fail, or TBTF. The argument is that, without politicians with skin in the game, TBTF banks will always be bailed out. As a result lenders will lend money to these banks at low interest rates and banks will engage in excessive borrowing and risk taking. However, if politicians were to see their personal wealth decline if they arrange a bailout, the likelihood of such bailouts will decline. This will in turn make lenders and banks more financially conservative and reduce moral hazard. This time, it will no longer be certain that any bank is too big to fail.

Under this new corporate governance mechanism, politicians would become the true captains of their ships: They will go down with it if it sinks, rather than safely watching from the shore. As a result, promises to be fiscally responsible will become credible. Battles against labor unions to cut pensions and welfare benefits will become battles for preserving a politician's personal wealth. Of course, he may well lose the next election as a result, but the financial rewards will compensate for the resulting reduction in power and prestige. And our children will be eternally grateful.

—Theo Vermaelen is professor of finance, INSEAD

## What's News

■ **Obama will promote** government spending and stimulus-style policies to his global counterparts at the weekend G-20 summit, but world leaders are more worried about the growing debts. 6

■ **Russia belongs** in the WTO, Obama said after holding talks with Medvedev in Washington. The two leaders also agreed to expand intelligence cooperation. 4

■ **Credit Suisse** named Eric Varvel as chief executive of its investment bank, and said current head Paul Caelelo will become chairman of the securities unit. 17

■ **Resolution agreed** to buy some of AXA's life operations for \$4.11 billion, aiming to build a dominant U.K. life insurer through the merger of several companies. 21

■ **A senior Polish security** official warned that NATO must change its approach in Afghanistan or risk a "strategic catastrophe." 5

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## ONLINE TODAY

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### The Source

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Katie Martin on the currency that's soaring to all-time highs.



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Q: Will the change in command in Afghanistan help or hurt the war effort?

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### Previous results

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## NEWS

**Broad impact** | The Supreme Court's ruling narrowing the law on honest-services fraud could affect prominent prosecutions of former business and political leaders. A look at some.



BUSINESS FIGURES

POLITICAL FIGURES

**Jeffrey Skilling**  
former Enron CEO

Sentenced to 24 years imprisonment in 2006 on charges related to collapse of the energy company and currently in federal prison. Supreme Court ruled he didn't commit honest-services fraud. Case goes back to lower courts to determine what parts, if any, of his conviction stand. Skilling said he tried to defend Enron and did nothing wrong.

**Conrad Black**  
former Hollinger CEO

Convicted in 2007 in prosecution that relied in part on honest-services fraud, and now serving a 6½-year prison sentence. Black was accused of siphoning off millions of dollars from his media conglomerate but he said the arrangements were legal. Supreme Court ruling sends Black's case to lower courts.

**Richard Scrushy**  
former HealthSouth CEO

Convicted in June 2006. Five of the six counts involved honest-services fraud. Now serving time in federal prison, but Supreme Court opinion could help him revive his defense. Scrushy denies wrongdoing.

**Rod Blagojevich**  
former Illinois governor

Now on trial in federal court in Illinois over corruption charges. Some counts are based on the honest-services law, but federal prosecutors brought other charges in anticipation of the high-court ruling. The trial judge on Thursday ordered the trial to continue. Blagojevich denies wrongdoing.

**Bruce Weyhrauch**  
former Alaska state legislator

Facing charges of failing to disclose job negotiations with an oil field operations company when state legislature was considering an oil bill. Is free pending appeal. In one-sentence opinion, Supreme Court threw out an appellate ruling that was unfavorable to Weyhrauch, and case goes back to lower courts for resolution.

**Don Siegelman**  
former Alabama governor

Convicted alongside Scrushy in June 2006 on counts that included honest-services fraud. In 2009, a federal appeals court upheld most of the conviction, but Supreme Court ruling could give Siegelman another chance. He is free while his appeal is pending. He denies wrongdoing and says his prosecution was politically motivated.

Sources: Supreme Court rulings; Associated Press

# Straight answers on honest services

BY NATHAN KOPPEL

The Wall Street Journal spoke to Robert Plotkin, the head of law firm McGuireWood's SEC Enforcement group. Mr. Plotkin defended Toronto Dominion Bank against civil fraud charges in connection with the Enron matter; the charges were dismissed.

## What does the court's ruling mean for honest-services law?

**Robert Plotkin:** This cuts back honest-services fraud significantly. The majority opinion said the statute should be limited to cases involving alleged bribes and kickbacks. [Former Enron President

Jeffrey] Skilling was not accused of that; he was said to have violated the honest-services law by depriving people of his responsibility as an officer of the company.

## How often do prosecutors bring honest-services cases?

It is one of the most common charges brought by the Justice Department in cases involving public officials or financial-type fraud. It's been popular because it's so malleable. When it looks like someone has done something unethical, prosecutors can use honest-services fraud to justify introducing evidence of whatever the alleged unethical behavior was, such as failing to dis-

close a conflict of interest. The government would have to work harder to get in that type of evidence under other theories.

## What sort of ammunition does this opinion provide defense lawyers?

In some cases, it could have a big impact. Former [Illinois] Governor Rod Blagojevich is in trial now and one of the charges against him is honest-services fraud. This will have an impact on his trial. Former Alabama governor [Don] Siegelman is appealing an honest-services fraud conviction, so this could have a significant impact in that case. If you can argue in ongoing cases that

there is no evidence of a fraud or kickback, the opinion could be a basis to dismiss that aspect of the case.

## Could the ruling help defendants who had already exhausted their appeals?

It's hard to know for sure at this point. There likely will be a round of challenges by defendants arguing that the opinion does have retroactive effect, and there likely will be a slew of lower-court opinions looking at that issue. It will take some time to sort it out.

## What's next in the Skilling case?

The Supreme Court said specifi-

cally that they are not throwing out his conviction. They are asking the Fifth Circuit to see whether or not there was any aspect of bribery or kickbacks involved in his case and thus whether his conviction as to honest services should stand or be reversed. Skilling was also convicted of insider trading and other charges, so, if the honest-services charge is thrown out it doesn't mean he's home free. The question becomes whether the evidence that came in under an honest-services theory, such as his alleged conflicts of interest, taint the other convictions. Did the jury, in other words, rely on that evidence to convict him of insider trading and securities fraud.

# Supreme Court upends Skilling and Black cases

Continued from first page

"In the solicitor general's office, we're interested in all of the cases," said Ms. Kagan, who has since been nominated to the Supreme Court herself. "In the rest of the Justice Department, this is a three-case term. And the cases are Black and Weyhrauch and Skilling."

Based on the court's ruling in the Skilling case, Justice Ginsburg said in a second opinion that the jury instructions in Lord Black's case were incorrect. Lord Black's case also will go back to lower courts that will weigh how to apply the Supreme Court's ruling.

Lord Black's lawyers predicted the onetime owner of London's Daily Telegraph and the Chicago Sun-Times soon would go free.

"We are confident the lower courts will quickly conclude that the errors that the Supreme Court has now conclusively found tainted every aspect of this case," lawyers Miguel Estrada and David Debold

said in a statement.

In a second part of the court's Skilling opinion, the justices rejected the Enron executive's other attack on his conviction, based on the argument that he did not receive a fair trial, in part because of intense news coverage in the Houston area.

Mr. Skilling's lawyers had contended that the economic damage Enron wreaked on its home city so poisoned the jury pool that his trial should have been moved elsewhere. At the very least, Mr. Skilling argued, the trial judge should have scrutinized potential jurors more closely to guard against possible bias. Jury selection in the case lasted just five hours.

Justice Ginsburg said Mr. Skilling failed to establish that actual bias infected the jury that tried him.

The court's 51-page Skilling opinion produced different lineups of justices on different legal questions. Five justices joined Justice Ginsburg

in ruling that Mr. Skilling's honest-services conviction was flawed. Another three justices, led by Justice Antonin Scalia, concurred in that result, but would have gone further and invalidated the entire federal honest-services statute as unconstitutionally vague.

The court voted 6-3 that Mr. Skilling received a fair trial.

Five justices joined Justice Ginsburg's opinion in favor of Lord Black, while another three justices concurred in that ruling.

Mr. Skilling's legal team had argued that his actions were taken to protect Enron and weren't motivated by personal gain. His lawyers said the crime of "honest services" fraud was too vaguely defined to be constitutional.

In Lord Black's case, prosecutors had alleged that the former chairman of Hollinger International Inc. and other executives supported lavish lifestyles by siphoning off millions from the company through bo-

gus management fees and noncompetition agreements as Hollinger sold off many of its smaller newspapers.

The prosecution alleged that the Hollinger executives stole the money, but in a related legal theory,

## Skilling's lawyers had contended that the economic damage Enron wreaked on its home city so poisoned the jury pool that his trial should have been moved elsewhere.

also alleged that the executives deprived Hollinger of their honest services as managers of the company.

Lord Black, who was convicted in 2007 and is serving a 6½-year prison sentence, had argued that the government's reliance on the hon-

est-services law meant that the jury could have convicted him even if it didn't believe he stole anything.

A jury convicted Lord Black on three counts of mail fraud and one count of obstruction of justice, though it acquitted him on nine other fraud counts.

Lord Black and the other executives said they did not steal from the company, but instead sought to structure certain management fees in a way that the payments they received would not be taxable.

Lord Black built Hollinger into what once was the world's third-largest newspaper company. At one time it operated more than 300 newspapers, including most newspapers in Canada. He renounced his Canadian citizenship to obtain a British title of nobility, and was admitted to the House of Lords on Halloween 2001.

The company is now much smaller and operates under the name Sun-Times Media Group Inc.

## EUROPE NEWS

# Obama touts Russia WTO bid

*U.S. president says accession would be good for the U.S., for Moscow and for world economy*

*A Wall Street Journal Roundup*

WASHINGTON—U.S. President Barack Obama heartily plugged Russia's bid to join the World Trade Organization, saying as he stood beside Russian President Dmitry Medvedev that "Russia belongs in the WTO."

Russia has long sought WTO membership, but U.S. support in the past has come with conditions. The two leaders said they hope to have technical issues that have stymied the effort to be resolved by the autumn.

Mr. Obama said at a joint news conference at the White House that Russia's addition to the WTO would be good for the U.S., good for Russia and good for the world economy.

Mr. Medvedev arrived in the U.S. earlier in the week and spent the beginning of his trip in Silicon Valley, where he visited technology companies such as networking giant **Cisco Systems Inc.** and microblogging operator **Twitter Inc.**

The purpose of the visit was, among other things, to strengthen economic ties between the two countries. During Mr. Medvedev's visit to Cisco, the company pledged to invest \$1 billion in Russian projects over the next decade.

Messrs. Obama and Medvedev were scheduled to travel later Thursday to the U.S. Chamber of Commerce, the country's largest business lobby. Mr. Obama said the visit at the chamber would include "major" trade-deal announcements. Before the press conference, the two men made an impromptu trip to a nearby burger joint for lunch.

Mr. Obama also said it is "too early to tell" whether China's agreement to let the yuan appreciate is sufficient to strike a rebalancing of the U.S. and Chinese currencies.

Speaking before the Toronto Group of Eight summit Friday and Group of 20 summit Saturday and



Presidents Obama and Medvedev eat burgers during a lunch at Ray's Hell Burger in Arlington, Virginia, on Thursday.

Sunday, he said his administration is watching China's currency moves closely and initial signs are "positive." China said last weekend that it would ease the yuan's nearly two-year-long peg to the U.S. currency.

Mr. Obama said the U.S. doesn't expect the yuan to appreciate rapidly "simply because that would be extremely disruptive to world currency markets and to the Chinese economy." He said he will leave it up to U.S. Treasury Secretary Timothy Geithner to determine the appropriate pace for the Chinese currency's appreciation. Still, Mr. Obama added, China has to make its own determination about the pace.

Mr. Obama also declared that he and Mr. Medvedev have "succeeded in resetting" the relationship be-

tween the former Cold War adversaries that had dipped to a dangerous low in recent years. He directly acknowledged differences in some areas, such as Moscow's tensions with Georgia, but said "we addressed those differences candidly."

The U.S. president announced that the U.S. and Russia had agreed to expand cooperation on intelligence and the counterterrorism fight and had worked on strengthening economic ties between the nations.

The leaders faced questions about the U.S.-led Afghanistan war, and Mr. Obama promised that the U.S. will "not miss a beat" because of the change in military command that he ordered on Wednesday.

Mr. Obama accepted Gen. Stanley McChrystal's resignation and re-

placed him with the general's direct boss, Gen. David Petraeus. Gen. Petraeus "understands the strategy because he helped shape it," Mr. Obama said.

Mr. Obama said the two had also agreed to coordinate on humanitarian aid for Kyrgyzstan, wracked by deadly unrest in the wake of the president's ouster there. Recent violence there is has left as many as 2,000 people dead, according to some reports, and 400,000 ethnic Uzbeks homeless.

The agenda for Obama and Medvedev was modest, and mostly focused beyond security issues to expanding trade and economic cooperation. Russia has the world's eighth-largest economy but ranks 25th among U.S. trading partners.

## Gazprom resumes supplies to Belarus

By JACOB GRONHOLT-PEDERSEN

MOSCOW—Russia and Belarus settled a dispute which had briefly interrupted the flow of natural gas to Europe.

The standoff, reminiscent of Russian gas disputes with Ukraine in previous years, briefly affected the European Union, highlighting what many policy makers say is the EU's need to diversify energy supply routes.

Russia had cut gas shipments to its former Soviet neighbor, saying it wanted Belarus to pay outstanding gas bills.

A key transit country for Russian energy supplies to Europe, Belarus in turn halted westbound shipments of natural gas, affecting Polish and Lithuanian importers.

Belarus refused to accept an increase in the price it pays for Russian gas and on Thursday, Russian state gas firm OAO Gazprom said it had resolved all payment issues and restarted natural gas shipments to Belarus.

Relations between Moscow and Minsk, traditionally close allies, have soured recently over trade and energy issues. Belarus President Alexander Lukashenko didn't join a customs union with Russia and Kazakhstan last month and has given refuge to ousted Kyrgyz leader Kurmanbek Bakiyev, while Moscow has shown support for the country's new leadership.

Moscow's move to cut gas was widely seen as an attempt to punish Belarus's government, which relies on cheap Russian energy supplies to keep its weak, isolated economy afloat.

—Alessandro Torello in Brussels contributed to this article.

# BOE: U.K. banks face refinancing hurdle

By NATASHA BRERETON

LONDON—British banks face a huge refinancing hump next year, but they should be able to surmount it unaided if they borrow money before it is needed and seek funds from a wider range of sources, the Bank of England said Friday.

In its Financial Stability Report, the central bank noted that British banks have lent only modestly to parts of Europe where concerns about government finances have been greatest, but cautioned that they have larger indirect exposure to those areas via banks in other countries, particularly in France and Germany.

It also called for a longer transition period for new international capital and liquidity requirements so that banks can become stronger by retaining a greater proportion of their earnings, while also supporting the real economy by sustaining lending.

"U.K. banks have raised their capital and liquidity buffers substantially, which has helped them weather recent tensions. But ... they face a number of challenges in the period ahead," the BOE said.

The semi-annual report—the first since the government confirmed that the central bank will take back responsibility for regulating the U.K. banking sector from the Financial Services Authority—highlighted the conflicting forces that are shaping banks' behavior.

Banks are under pressure to store capital as investors fret over sovereign creditworthiness and, over the longer term, as new regulatory requirements come into effect. But it is vital for their profitability that they continue to support economic growth through greater lending.

The BOE report showed that the U.K.'s largest banks will need to refinance or replace £750 billion to £800 billion (\$1.121 trillion to \$1.196 trillion) of loans and liquid assets by the end of 2012, with more than £250 billion falling due next year.

That would require banks on average to borrow £25 billion every month over the coming 2½ years—far in excess of their average monthly debt issuance of £12 billion so far this year.

The refinancing burden includes £165 billion in long-term funding via the central bank's Special Liquidity

Scheme, which the BOE has stressed will close in 2012 as planned, despite some calls to keep it open.

Banks also need to extend the maturity of their wholesale borrowings, the BOE said. Now, around 60% falls due within one year.

A key risk to the U.K. financial system is that the risk aversion because of concerns about the financial health of some indebted countries will endure, making it harder for banks to refinance themselves and pushing down the value of their assets. If capital becomes scarcer, it also could constrain economic growth, increasing the likelihood of souring loans, it said.

European Union finance ministers and the International Monetary Fund agreed last month to commit €750 billion (\$923.25 billion) to support euro-zone governments that have difficulty borrowing in the bond markets, while the European Central Bank began to buy euro-zone government bonds in an effort to bring down borrowing costs. The U.S. Federal Reserve simultaneously reopened dollar swap lines with several major central banks.

While U.K. banks' direct claims on Greece and other small European

economies that are facing economic pressures are quite small, a number of banking systems within the euro zone do have significant exposures to such countries, the BOE said.

It noted that banks in France and Germany have a large aggregate exposure to Spanish borrowers.

"U.K.-owned banks are particularly exposed to the French and German banking systems, which account for around one quarter of their claims on banks globally," it said.

Furthermore, a broad-based rise in sovereign risk concerns would tend to lower banks' long-term credit ratings, since they benefit from the implicit support given by governments, the BOE said, adding: "U.K. banks are among those vulnerable to these pressures."

The BOE noted that debt issuance by banks this year has been patchy, partly due to market tensions over euro-zone sovereign concerns. "This illustrated the vulnerability of banks' issuance plans to disruption by wider events and the importance of banks taking a far-sighted and strategic approach to treasury management," it said.

Relying to a greater extent on

money-market funds and other asset managers, such as insurance companies and pension funds, might help banks to achieve that aim.

Given recent market strains, greater transparency is extremely important to maintain the confidence of overseas investors, which U.K. bank rely upon for short-term funding.

The BOE warned banks against making optimistic assumptions about their ability to attract retail deposits, given that they will face aggressive competition, both at home and overseas.

The central bank urged banks to redouble their efforts to retain a greater proportion of their profits, saying there remained "scope" to build up their capital buffers further while at the same time sustaining lending to the real economy.

Progress made so far in retaining profits has been achieved largely through increasing revenue rather than by lowering costs, it noted.

The BOE praised a sharp reduction in leverage levels, which it said had been achieved through issuance of equity and sales of assets, without curbing lending to the real economy.

## EUROPE NEWS

# Europe takes aim at defense budgets

European governments' budget-slashing efforts are expected to cut deep into the Continent's defense spending, widening the gulf between U.S. and European military capabilities.

By Stephen Fidler,  
Alistair MacDonald  
And Patrick McGroarty

Governments in France, Germany, Spain and Italy, in rolling out recent austerity measures in response to Europe's sovereign debt crisis, have promised that their militaries won't be spared. This week in the U.K.—which has Europe's biggest military budget—new defense minister Liam Fox said the government must act “ruthlessly and without sentiment” in determining the military's share of cuts needed to tackle the country's giant budget deficit.

In the short term, tight finances don't appear likely to affect European deployment to Afghanistan, where 40,000 troops, mainly from Europe, are on the ground with 78,000 Americans. “There has been no indication that any government has contemplated to reduce its commitment to Afghanistan for financial reasons,” said Ivo Daalder, the U.S. ambassador to the North Atlantic Treaty Organization, which leads the Afghan effort.

But in the longer term, cuts in defense spending are seen as likely to reduce European appetite to send troops there. Falling European defense expenditures will also further increase the spending gap with the U.S., which spends more than twice as much on its military than all its European allies combined.

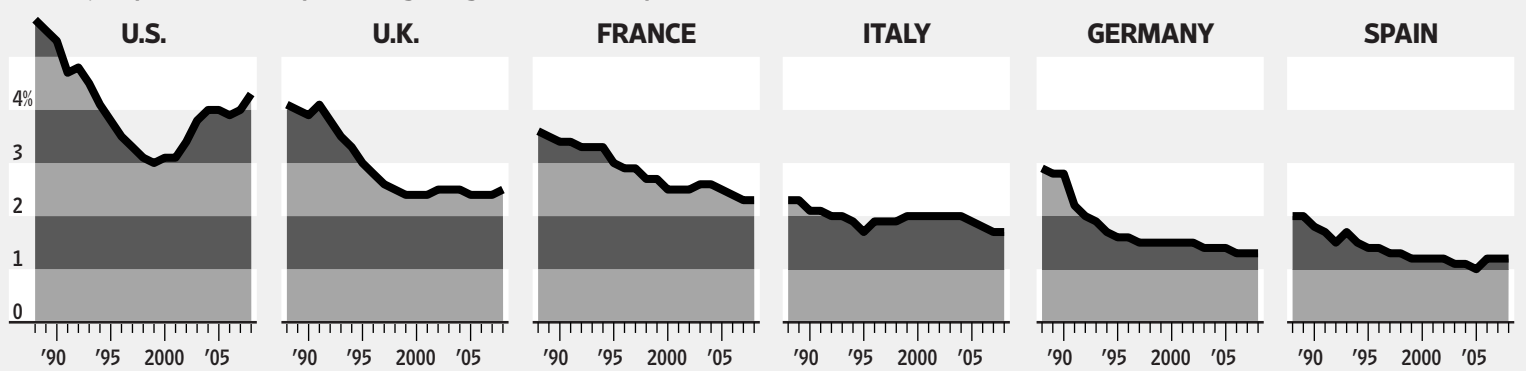
This week, Anders Fogh Rasmussen, head of the 28-nation NATO, called on European countries to “resist the temptation to use the economic crisis as an excuse for letting the transatlantic defense-spending gap widen any further.”

Military spending in most European countries is already below 2008 levels. Spain's defense spending has fallen by almost 9% this year, or more than €600 million (\$740 million), adding to last year's €400 million cut. Italy plans to slash defense spending, too, as part of an austerity package it announced last month.

Earlier this month, Germany announced more than €80 billion in overall spending cuts through 2014, about 10% of which is expected to come from its defense budget. A few

## Atlantic divide | As U.S. defense spending climbs, most of Europe is making cuts

### Military expenditure as a percentage of gross domestic product



### Defense expenditures, 2008, in billions



days later, the French Defense Ministry also said it will seek to reduce its budget, which stood at €32 billion in 2010, by as much as €5 billion next year.

Europe could spend less but spend better, defense analysts say. At the end of 2008, the countries of the European Union had 1.8 million men and women under arms, compared with 1.4 million in the U.S., according to the European Defence Agency, an EU body. It spent more than the U.S. on personnel—€106 billion versus €93 billion—but deployed 80,000 troops on operations, compared with 210,000 for the U.S.

Most European military establishments are still structured as they were in the Cold War. “We should not continue to invest our scarce resources in fixed infrastructure and soldiers who are essentially stuck in their barracks. We should redirect our investments towards more flexible, mobile and modern armed forces—armed forces that we can actually use,” Mr. Rasmussen said.

Analysts worry that while budget cuts haven't so far affected NATO operations in Afghanistan, the operation and the broader alliance could come unglued in the longer term.

If Europe fails to shape its militaries “into a realistic defense capability, then NATO will fail at its task and the main link between Europe and the U.S. will effectively cease to exist,” said Chris Donnelly, an inde-

pendent defense consultant and director of the U.K.'s Institute of Statecraft and Governance.

Most countries haven't specified where the ax will fall, but analysts say some prestigious, big-ticket programs are likely to be hit. Nick Witney, a former head of the European Defence Agency now at the European Council on Foreign Relations, said fighting forces “are going to have to make do with the [ship] hulls they have and the aircraft they have.”

The U.K. government, which provides the largest contingent to Afghanistan after the U.S., has said it will spell out the cuts only after completing a thorough review of Britain's defense strategy. But the defense minister, Dr. Fox, a former Army doctor, has promised “a clean break from the military and political mindset of Cold War politics.”

Military analysts say this may be bad news for one or both of the new fast-jet programs in which the U.K. is involved—further tranches of the Eurofighter, a joint project of several European countries, or the F-35 Joint Strike Fighter, in which Britain is cooperating with the U.S. They also say the army may be shrunk from its current size of 100,000 by up to 20,000.

With the British army heavily stretched by its deployments over the past decade in Iraq and Afghanistan, cutting troop numbers by that

much would assume “a very limited appetite for further overseas adventures in the next decade or so,” Mr. Witney said.

Since 1997, when the last Labour government came to power, the number of people in the U.K. armed forces has been cut around 20%. “Is there a lot of fat to trim? No,” said Patrick Hennessy, who commanded a platoon of Grenadier Guards in Iraq and Afghanistan.

German Defense Minister Karl-Theodor zu Guttenberg wants to eliminate 40,000 troops from a current force of 250,000 professional and conscripted soldiers. He plans to present his vision for Germany's military, the Bundeswehr, in September.

Analysts say the Bundeswehr needs to be revamped to address the realities of shifting security threats beyond Germany's borders. The military remains too anchored to its network of bases in Germany, said Henning Riecke, an expert on transatlantic relations at the German Council on Foreign Relations in Berlin, and too reliant on large, aging tanks and artillery.

A thriffter Bundeswehr might irk some NATO members. New members from eastern Europe are directed to spend 2% of their gross domestic product on defense, Mr. Riecke said, while German defense spending, currently around 1.5% of GDP, is moving closer to 1%. German defense minister Mr. Guttenberg, a rising political

star in Germany and a member of the Christian Social Union, the Bavarian sister party to Chancellor Angela Merkel's conservative Christian Democratic Union, caused an uproar earlier this month by suggesting conscription be eliminated, bringing forth a defense from Ms. Merkel of Germany's place among five NATO countries with an active draft.

For some countries, cutting down on military personnel and expenditures will be tough. Italy's army, for example, is overloaded with non-commissioned officers, recruited for life two decades ago to run a conscript army. Now the conscripts are no longer there, but the NCOs are still in place. Moreover, in many countries, military pensions are paid out of the military budgets.

Mr. Witney says pressure on budgets might, in time, lead to more sharing of military assets among allies. He sees the possibility of saving money through joint military procurement projects, for example, between France and Britain.

NATO's “footprint” in Europe is also likely to shrink. The alliance employs more than 11,000 people in its military headquarters and agencies. Earlier this month, NATO defense ministers discussed cutting an unspecified number of its 12 military headquarters around Europe.

—David Gauthier-Villars  
and Santiago Perez  
contributed to this article.

# Poland warns on NATO's Afghan strategy

By GORDON FAIRCLOUGH  
AND MARCIN SOBczyk

A top Polish security official warned that the North Atlantic Treaty Organization needs to change its approach in Afghanistan or risk a “strategic catastrophe,” as allied political support for the U.S.-led counterinsurgency campaign there wavers.

Stanislaw Koziej, a retired general who is director of Poland's National Security Bureau, wrote in an analysis made public Thursday that NATO forces stationed in Afghanistan are just “passively waiting” for developments as the situation there grows “continuously worse.”

Public opinion and official views in Poland, a staunch U.S. ally that

has contributed troops to the U.S.-led war efforts in Iraq and Afghanistan, have been shifting against the country's further involvement in the Afghan conflict.

More than 2,500 Polish troops are now serving in Ghazni, southwest of Kabul; 18 Polish soldiers have been killed in the conflict.

The comments by Mr. Koziej come a day after U.S. President Barack Obama dismissed the top U.S. and NATO commander in Afghanistan, Gen. Stanley McChrystal, and nominated Gen. David Petraeus to succeed him.

Mr. Obama said the U.S. would stay on its current strategic course in Afghanistan, with a plan that melds military action and economic development efforts. The U.S. has

boosted the number of troops it has deployed in the country. More will be in place by the end of August.

Still, in Mr. Koziej's assessment, NATO's position in Afghanistan is “deteriorating.” He said the resistance movement there is becoming “increasingly active and strong” and winning support from Afghan security forces as well as ordinary citizens.

He said Poland can't afford to increase its engagement in Afghanistan further and that the tasks already taken on by Polish forces exceed their capacity. He called for scaling back allied goals and limiting them to preventing Afghanistan from threatening other nations.

Mr. Koziej warned that decisions by Canada and the Netherlands to

pull out next year “could be seen as the beginning of allies backing out,” which could lead to a rush to withdraw “that will be impossible to stop.”

He said Poland should propose that NATO “redefine the goal of engagement from offensive to defensive,” giving up on the goal of turning Afghanistan into a reliable ally and instead coming up with a plan to effectively protect itself from any future Afghan threat.

Bronislaw Komorowski—the leading candidate in opinion polls for Polish presidential elections to be held July 4—said Tuesday that he wants Poland to begin withdrawing troops from Afghanistan next year and have none left there by 2012.

Mr. Komorowski, who has served as acting head of state since the death of President Lech Kaczynski in an April plane crash, said that Poland needs to “redefine its presence in Afghanistan and to propose to redefine the rules of the NATO mission.”

He said NATO countries should shift to focus on civilian rather than military efforts to transform the troubled country and prevent it from again becoming a haven for terrorists.

The head of the Polish government, Prime Minister Donald Tusk, who belongs to the Civic Platform party, the same party as Mr. Komorowski, has also called on NATO to begin discussing a strategy for its withdrawal from Afghanistan.

## G-20: TORONTO

# Obama faces hurdles on growth

*President to promote spending, stimulus at summit, but counterparts, Congress still wary*

BY ELIZABETH WILLIAMSON

WASHINGTON—President Barack Obama wants to sell world leaders on his ideas for sustaining global economic growth.

One reason that won't be easy: He hasn't yet convinced the U.S. Congress.

The president leaves Friday for the Group of 20 summit in Toronto, where he will promote government spending and stimulus-style policies to his global counterparts, who these days are more worried about growing debts.

Meanwhile, Democrats in Congress are struggling to pass even the most basic spending measures amid fears over the federal deficit, and an influential group of U.S. corporate leaders this week accused Mr. Obama of retarding growth with a slew of new taxes and rules.

More than \$860 billion in stimulus spending enacted last year has failed to move the nation's jobless rate much below 10%, and polls show Americans question its effectiveness.

The federal deficit reached \$1.4 trillion by the end of last year, its highest level since World War II.

On Thursday, the Senate remained deadlocked over a package of tax cuts and federal benefits for businesses, the unemployed and state governments.

Like many of the president's job-creation and growth proposals, the bill was repeatedly scaled back as Republicans and some Democrats balked at its cost.

Even a one-time \$250 payment to Social Security recipients—a group sacrosanct in an election year—looks doomed.

The current bill would cost \$105 billion over the next decade, \$60 billion of it offset by tax increases on multinationals.

That last part has irked business leaders, who have protested the bill as a brake on job creation.

Last week, the Business Roundtable—composed of the nation's biggest corporations—used a report they prepared at the request of the president's budget director to launch a rare broadside against the White House.



Toronto police inspect the area after arresting the driver of a car containing suspicious items near the G-20 meeting site.

Executives from the group, many of whom have advised the president on the economy, listed dozens of regulations and policies that they say have slowed growth.

"By reaching into virtually every sector of economic life, government is injecting uncertainty into the marketplace and making it harder to raise capital and create new businesses," **Verizon Communications Inc.** Chief Executive Ivan Seidenberg said.

William McComb, chief executive of global apparel conglomerate **Liz Claiborne Inc.**, backing the president's G-20 message, warned of the dangers that could accompany a sudden spending retrenchment.

"One risk of the European governments speaking to austerity as the key message is that it will in fact create a consumer mindset of true austerity—and self-fulfill economic contraction," he said.

Mr. Obama heads to the meeting with some solid achievements.

When he attended his first G-20 summit last spring in London, the U.S. economy was shrinking at an

annual rate of 6%. Now it is growing at a rate of 3%.

An overhaul of financial-market rules, seen as essential for avoiding another economic crisis, is within days of likely passage in Congress.

And China's recent move to revalue its currency removes a big point of international attention.

Greece's debt crisis has nervous governments across Europe slamming the brakes on spending.

Mr. Obama sent a letter this week to G-20 members urging them not to withdraw support for growth too quickly.

It was rebuffed two days later by European leaders.

"Europe is determined to ensure fiscal sustainability and achieve budgetary targets without delay," reads the letter issued Tuesday by European Council President Herman Van Rompuy and European Commission President José Manuel Barroso.

"There is a need for credible medium-term fiscal policy strategies to bring down deficit and debt ratios," it adds.

Europeans are placing greater emphasis on trade to boost growth. Mr. Obama says he aims to double American exports over the next five years.

But the administration has moved slowly to conclude new trade agreements and resolve some disputes, bowing to labor and other special interests.

That was another impediment to growth cited by corporate leaders.

A senior White House official said the G-20's big players aren't as far apart as they seem, and there is still room to address budget concerns while nurturing a still-fragile recovery.

"Leadership by example is part of what we bring to the G-20...and the steps he's taken on economic recovery and the stimulus has started the process of growing the American economy again," the official said of Mr. Obama.

"He retains a lot of popularity and enthusiasm in much of the world—of course not without challenges and frustration."

## Cameron brings skepticism to world stage

*Continued from first page*  
gatherings—particularly the G-8—to deliver on stated pledges.

"The G-8 needs to demonstrate to the public that when we get together and sign up to these things, we mean it," he said. The U.K. has complained before that goals set to provide aid to the poorest nations at the 2005 G-8 summit in Gleneagles, Scotland, haven't been met by some of the countries that signed on.

"That is why I think there is an accountability issue, on aid delivery and promises made," he said.

The U.K. often wields greater influence at international get-togethers than its size would suggest, a phenomenon that in recent years was fed by the enthusiasm for such events shown by U.K. leaders like Mr. Brown. But Mr. Cameron enters this weekend's meetings having focused mostly on domestic affairs, both in his first six weeks as prime minister and in the previous five years as the leader of Britain's Conservative Party.

"Cameron has been very much a man for domestic affairs, and has no real foreign-affairs expertise and never has done," said Tim Bale, a lecturer in politics at the University of Sussex who recently wrote a book on the Conservatives.

As an opposition leader, Mr. Cameron did little to cultivate foreign politicians, in the way that Tony Blair and the Labour Party did ahead of their 1997 victory, as they crisscrossed the U.S. and Europe.

Mr. Cameron, for instance, is relatively unknown among the ranks of U.S. Republicans, where his Tory party has traditionally enjoyed close ties, and only visited Washington once as leader of the opposition.

Still, Mr. Cameron is a big-picture thinker and a man of relaxed charm who doesn't have the same social awkwardness as his predecessor, Mr. Brown. A spokeswoman for the prime minister said Mr. Cameron has shown interest and engaged in international affairs, particularly on European issues. As opposition

leader, he met with global leaders including French President Nicolas Sarkozy, Germany's Angela Merkel and Mr. Obama, and typically met with foreign leaders when they visited London, she said.

At this week's meetings, Mr. Cameron will hold a meeting with Mr. Obama and has plans to meet other non-European leaders.

While the main focus of the G-20 meeting will be on the economy, Mr. Cameron will also push Britain's foreign-policy agenda. The war in Afghanistan, where more than 300 British troops have died, tops it.

Mr. Cameron is also looking to widen the U.K.'s ties outside its core relationships with the U.S. and Europe, increasing trade with large emerging economies such as China, India and Brazil. In the coalition agreement the Conservatives struck with the Liberal Democrats, establishing a "new 'special relationship'" with India is listed above maintaining a "strong, close and frank relationship" with the U.S.

The U.K. is also an aggressive voice against Iran's nuclear program and has been a vocal advocate of development for the world's poorest economies; its Department of International Development was one of only two departments shielded from aggressive budget cuts.

Though he never managed to connect at home, foreign affairs often proved Mr. Brown's strong hand. He was seen as taking a lead in the response to the credit crisis—the U.K.'s bank-bailout plan was imitated by other countries—and the morning after the G-20 summit in London in April 2009 gave him one of his only rounds of positive front pages in the British press.

"He was a remarkably effective statesman in the context of both the G-8 and G-20 summits," said Daniel Price, who dealt with Mr. Brown as G-8 and G-20 adviser to then-President George W. Bush. "He brought important ideas to the table, in the areas of global financial reform and economic development."

## Protesters were rallying before leaders even arrived

BY MONICA GUTSCHI

TORONTO—Before leaders of the world's biggest economies began arriving in Toronto, groups were already in the city protesting their policies.

A variety of groups have been holding rallies, marches, movie screenings and other events for most of June in a bid to call attention to the issues they say members of the Group of 20, meeting in the city this weekend, routinely ignore. There was a "People's Summit" last week at which organizations as diverse as Amnesty International and Bikes Not Bombs Toronto held meetings and seminars that ostensibly mimicked the G-20 discussions, set to get under way Saturday.

"Themed Days of Resistance" have taken place with different protests targeting G-20 policies on gender equality, climate change, indigenous peoples, poverty, maternal rights, the rights of homosexuals, transsexuals and others, and the rights of union workers.

"We just really wanted to make sure issues were covered really, really, clearly in advance," said Syed Hussain, spokesman for the Toronto Community Mobilization Network, which is helping coordinate the many protest groups.

So far, the protests have been relatively small and peaceful. Protesters' "rights are being inhibited by overkill security measures," said Dylan Penner, spokesman for the Council of Canadians. He noted that many groups involved in organizing the anti-G-20 events are worried police could use sound and water cannons, rubber bullets and tear gas to control the crowds.

There have already been a handful of arrests. Around midday Thursday, police arrested a driver of a car laden with an "array of weapons," said police spokesman Sgt. Tim Burrows. News reports from the scene said the car contained five gas canisters, a chain saw and a homemade crossbow. The car was detained a few blocks east of the security perimeter surrounding the convention center.

Const. Wendy Drummond, spokeswoman for the Integrated Security Unit which comprises a number of police forces led by the Toronto Police and the Royal Canadian Mounted Police, said charges brought against those who have participated in the marches and demonstrations to date have been "criminal code offenses not relevant to the protests."

Organizers say they expect thousands of people to participate in Friday's Day of Action and Saturday's march through downtown Toronto. The event begins as a demonstration at a park to the northeast of the Metro Toronto Convention Centre where the G-20 summit is being held, then turns into a block party and then a tent city, says Mr. Penner.

The Saturday march, which begins at the site of the Ontario Legislature and the area police have designated for protesters, is to proceed down University Avenue to the perimeter fence surrounding the convention center. "We'll be getting as close as possible," Mr. Penner says, "to express people's outrage at the policies of the G-20."

## U.S. NEWS

# Yale scientists build rat lung in lab

Complex organ is the latest in a series of groundbreaking experiments in the hot field of regenerative medicine

BY GAUTAM NAIK

Scientists have made partly functioning rat lungs in the laboratory, a small yet tantalizing step in the quest to create fresh body parts for transplantation or to treat disease.

A team led by researchers from Yale University took apart rats' lungs and rebuilt them with new cells in a glass jar. When transplanted into live rats for a few hours, the new organs successfully exchanged oxygen and carbon dioxide, just as natural lungs do. The findings are published in the online version of the journal *Science*.

The study, funded by Yale and the National Institutes of Health, builds on a handful of similar groundbreaking experiments of recent years. A breakthrough using the same technique occurred in 2008, when University of Minnesota researchers created a beating rat heart in the lab. In a June 13 paper in *Nature Medicine*, scientists from Massachusetts General Hospital and elsewhere described how they had used the method to create a rat liver.

"It's an approach that has repeatedly been shown to have promise," said Anthony Atala, an expert in regenerative medicine at Wake Forest University Baptist Medical Center, who wasn't involved in the latest study. Dr. Atala cautioned, however, that it could be years or even decades before such experiments could be tried in people.

Regenerative medicine is a hot field. Lab scientists are trying to regenerate everything from simpler body parts—skin or arteries—to more complex organs, such as the uterus. In 2006, Dr. Atala and his colleagues described how they used a patient's tissue to create the first lab-made bladder. More challenging yet is the effort to remake solid organs, such as the liver and lung.

There's a growing medical need. At the end of 2009, more than 105,500 patients were on the U.S. organ-transplant waiting list, according to the United Network for Organ

**Breathing new life** | A tantalizing step closer to growing a new lung

**Detergent washing**  
A detergent is used to dissolve all the cells contained in a rat lung.

**A clean slate: The matrix**  
Left behind is a scaffold of connective tissue known as a matrix, which retains the stretchiness and mechanical properties of the original lung.

**Adding fetal cells**  
Fetal lung cells and nutrients are injected onto the matrix. After a few days, the fetal cells repopulate the matrix forming the complex branching structure typical of any lung.

The lab-grown lung is transplanted into a living rat and partly functions as a normal lung.

Source: *Science*  
Photos: Thomas Petersen and Laura Niklason, Yale University

Sharing, up from some 67,200 a decade earlier. Some 83,180 of those patients last year were awaiting a kidney, while 15,845 needed a liver and 1,861 needed a lung.

Lung diseases, such as cystic fibrosis and cancer, kill 400,000 people in the U.S. each year. But regenerating lung tissue is hard. Today, the only option is to transplant an entire lung obtained from a cadaver. Fewer than 20% of patients who have a lung transplant are still alive after 10 years.

Laura Niklason, a professor at Yale, and lead author of the latest *Science* paper, tried an alternative approach in rats. The idea is to strip down a lung to its basic infrastructure, then repopulate it with fresh, lab-grown cells.

A lung is complex. Alan Russell, director of the McGowan Institute for Regenerative Medicine, likens it to a big city: If skyscrapers are

equivalent to cells, then a city's underlying infrastructure—roads, sewers, phone lines and electrical cabling—are akin to a lung's "extracellular matrix." This matrix sends out biological signals, attracting cells to the right locations and helping them to function in the right way, says Dr. Russell, who wasn't involved in the study.

Dr. Niklason and her colleagues first used a mild detergent to dissolve all the cells contained in the lungs of dead adult rats. Left behind were the underlying structures of the airways and vascular system, plus the matrix, which is made of collagen and other proteins.

The Yale researchers suspended the matrix in a glass jar. Lung cells taken from rat fetuses were injected into the setup, along with nutrients that helped the cells grow. Within days, the matrix had done its magic. The fetal cells repopulated the ma-

trix, forming the complex branching structure typical of a lung.

"It looked like a lung, it was pink and it had the same shape," said Dr. Niklason.

But could it function as that complex organ, whose thousands of branching airways contain millions of air sacs that exchange oxygen and carbon dioxide? As a test, the researchers cut out one lung in each of four adult rats and replaced them with their lab-grown versions.

The results were encouraging. For brief periods (45 to 120 minutes), the engineered lungs exchanged oxygen and CO<sub>2</sub> at 95% of the efficiency of natural lungs. Longer term, scientists will have to regenerate entire lungs in larger animals before trying it in people.

Dr. Niklason is the scientific founder and a director of Humacyte, a regenerative medicine company in which she owns stock. The authors

and Yale have filed for a patent.

For a patient, the matrix would have to be obtained from a cadaver. Luckily, a transplanted lung matrix probably wouldn't trigger an immune rejection the way a transplanted organ would, according to the researchers. "Your collagen is the same as my collagen, down to the last amino acid," said Dr. Niklason.

Not so for cells. Tissue introduced from outside a patient's body will generate an undesirable immune response. To seed the matrix, scientists could scrape healthy cells from the patient's own lungs. Or they could take a patient's skin cell, say, change it to an embryonic-like state in the lab and then persuade it to become fully functioning lung tissue.

No one yet knows if that's possible. "We've laid train track through the mountains," said Dr. Niklason, "but we're not yet through to the other side."

## Americans' confidence in Obama is waning

BY PETER WALLSTEN  
AND ELIZA GRAY

Americans are more pessimistic about the state of the country and less confident in Barack Obama's leadership than at any point since Mr. Obama entered the White House, according to a new Wall Street Journal/NBC News poll.

Sixty-two percent of adults in the survey feel that the country is on the wrong track, the highest level since before the 2008 election. Just one-third think the economy will get better over the next year, a seven-point drop from a month ago and the low point of Mr. Obama's tenure.

Amid anxiety over the nation's course, support for Mr. Obama and other incumbents is eroding. For the first time, more people disapprove of Mr. Obama's job performance than approve. And 57% of voters would prefer to elect a new person to Congress than re-elect their local representatives, the highest share in 18 years.

The results show "a really ugly

mood and an unhappy electorate," said Democratic pollster Peter Hart, who conducts the Journal/NBC poll with GOP pollster Bill McInturff.

Mr. McInturff said voters' feelings, typically set by June in any election year, are being hardened by frustration over the economy and the oil spill. "It would take an enormous and seismic event to change the drift of these powerful forces before November," he said.

For Democrats, the results underscore the potential for major losses in November. Both parties have been forced to contend with an anti-establishment wave this year. But Republicans, through strong fund raising and candidate recruitment, have put enough seats in play in the House and Senate to give the GOP a realistic shot at winning control of both chambers.

Support for Mr. Obama and his party is declining among centrist, independent voters. But, more ominous for the president, some in his base also are souring, with 17% of Democrats disapproving of Mr. Obama's job performance, the high-

est level of his presidency.

Approval for Mr. Obama has dropped among Hispanics, too, along with small-town residents, white women and seniors. African-Americans remain the firmest part of Mr. Obama's base, with 91% approving of his job performance.

Some 30% in the poll said they "do not really relate" to Mr. Obama. Only 8% said that at the beginning of his presidency.

Fewer than half give him positive marks when asked if he is "honest and straightforward." And 49% rate him positively when asked if he has "strong leadership qualities," down from 70% when Mr. Obama took office and a drop of eight points since January.

Just 40% rate him positively on his "ability to handle a crisis," an 11-point drop since January. Half disapprove of Mr. Obama's handling of the oil spill, including one in four Democrats.

In the survey, 45% said they wanted to see a Republican-controlled Congress after November, compared with 43% who wanted

Democratic control. Even more telling is the excitement gap between the core voters of each party.

Just 44% of Obama voters—those who voted for Mr. Obama in 2008 or told pollsters they intended to—now express high interest in the midterm elections. That's

a 38-point drop from this stage in the 2008 campaign.

By contrast, 71% of voters who supported Republican John McCain in 2008 expressed high interest in this year's elections, slightly higher than their interest level at this stage in that campaign.

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## U.S. NEWS



Getty Images

Interior Secretary Ken Salazar testified before a Senate energy panel Thursday.

## U.S. is dealt blow on oil-drilling ban

*Judge denies motion to keep moratorium*

By NAUREEN S. MALIK  
 AND SIOBHAN HUGHES

A federal judge Thursday refused to allow the Obama administration to continue its ban on new deepwater oil drilling while it pursues an appeal of an earlier ruling striking down the moratorium.

Separately, U.S. Interior Secretary Ken Salazar told a Senate panel Thursday that he still hopes to bar new deepwater drilling until "we get to a level where we can provide a sense of safety to the American people that drilling can, in fact, continue."

President Barack Obama ordered the halt on new drilling in late May as part of a series of actions in response to the Gulf oil spill. An oil-service company challenged the ban in federal court on the grounds that the moratorium was imposed arbitrarily and without following the proper processes.

On Tuesday, U.S. District Court Judge Martin Feldman in New Orleans sided with the oil industry, finding that the moratorium was an arbitrary decision that had an "immeasurable effect" on the Gulf Coast economy.

Mr. Salazar has indicated that he is working to re-make the ban to respond to Judge Feldman's decision. "How that will all come together is something that we're working on,"

Mr. Salazar told the Senate Energy and Natural Resources Committee Thursday.

The Obama administration has said it would appeal Judge Feldman's ruling with the New Orleans-based Fifth U.S. Circuit Court of Appeals.

Judge Feldman gave Mr. Salazar 30 days rather than 21 days "to report compliance" with Tuesday's order. Officials from the Interior Department referred questions to the Department of Justice, whose officials weren't available for comment.

Judge Feldman ordered the Administrative Office of U.S. Courts to release the most recent disclosure of his own financial interests. Intervenor in the lawsuit had filed a motion requesting the information after recent disclosures showed that the judge had investments in the energy sector.

Judge Feldman also denied a motion Thursday by the plaintiffs, including **Hornbeck Offshore Services LLC**, to enforce his own injunction. This means the government can file an emergency motion with the appeals court asking them to keep in place the drilling moratorium until the legal fight is resolved.

An official in the Fifth Circuit clerk's office has said that the court has emergency three-judge panels on standby to handle emergency motions.

## Jobless claims decline

By CONOR DOUGHERTY

The number of Americans filing new claims for unemployment insurance fell last week and large-scale layoffs for May hit the lowest level since the earliest days of recession, both encouraging signs for the still-ailing U.S. job market.

Initial claims for unemployment insurance declined 19,000 to a seasonally adjusted 457,000 for the week ended June 19, the U.S. Labor Department said Thursday. The

four-week moving average, which smooths out week-to-week volatility, fell 1,500 to 462,750.

A separate Labor Department report showed that in May there were 1,412 mass layoff announcements, which is when 50 or more people are laid off at once. That was the lowest number since April 2008.

"The evidence suggests that it's still a grudging recovery," said Joshua Shapiro, chief U.S. economist at research firm MFR Inc. in New York.



## WORLD NEWS

# Gillard vows Australia vote soon

*New Labor prime minister says she will seek fresh mandate, but decisions on mining tax, emissions may dog her*

New Australian Prime Minister Julia Gillard, having won the office in a Labor Party mutiny that drove Kevin Rudd from power, promised Thursday to go to the polls in "coming months" for a fresh mandate from voters.

By Rachel Pannett in  
Canberra and Alex Wilson  
and David Fickling in  
Melbourne

But for a party Ms. Gillard said had "lost its way" under Mr. Rudd, the challenge will be winning that mandate. The former prime minister's plunging approval rating—at 41% earlier this month, down from 74% in March 2009—was seen as putting his government in danger of becoming the first since World War II not to secure a second term. By law, the next election must be called by April.

Now Ms. Gillard, a Welsh-born 48-year-old former trial lawyer and the first woman to serve as the country's prime minister, must find a way through the same issues that brought Mr. Rudd down.

First among them is a controversial 40% tax on the "super profits" of Australia's mining companies, proposed last month. Also playing a part in Mr. Rudd's demise was a decision to shelve a carbon-emissions-trading plan that had been a key climate-change promise in his 2007 campaign—a decision in which Ms. Gillard acknowledges a role.

The mining tax, which the government thought would win popular support by spreading the wealth from a booming sector, instead fueled public worry about Australia's credibility as an investment destination, and, less of a surprise, led to a hostile standoff with a critical industry for the resource-rich country. Mining companies were furious that they weren't consulted before the tax was announced and that, in subsequent discussions, many of their key complaints were ruled off-limits by the government.

"The election will be over the tax," said pollster Roy Morgan.

Ian McAllister, head professor at the Australia National University's School of Politics and International Relations, said Ms. Gillard "absolutely has to" back away from the tax. "She can't buy into a fight with the miners in an election year."

In her first speech as prime minister, Ms. Gillard called for a truce. She quickly claimed an early success when global mining giants **BHP Billiton Ltd.** and **Rio Tinto Ltd.**, along with the industry lobbying group called the Minerals Council of Australia, agreed to her request that



New Australian Prime Minister Julia Gillard appears with her new deputy, Wayne Swann, in Canberra on Thursday.

they suspend their antitax ads. The government likewise canceled its ads in support of the tax.

"Already we are seeing our goodwill reciprocated," Ms. Gillard said. "This does give me confidence that there is room for negotiation, there is an ability to work together in the spirit of goodwill."

A BHP spokeswoman said the company was "encouraged by the comments" seeking consensus, while a Rio Tinto spokesman called them "a positive first step." Mitch Hooke from the mineral council said his group had acted "in the expectation that consultations will be meaningful and constructive." Mining stocks rallied Thursday on expectations the tax proposal would be overhauled.

But the pleasantries didn't narrow the distance between the two sides—and it isn't hard to find deep skepticism in the mining industry. Ms. Gillard offered assurances that the budget will be back to a surplus in 2013, a feat that relies on either a windfall from the new mining tax or a reversal on a promised cut to the corporate tax rate. Skeptical miners also note that Treasurer Wayne Swan, the tax's chief champion, not only kept his position but was promoted to deputy prime minister.

"Wayne Swan is the architect of this tax and he has been virulently opposed to any compromise, so it would be a big back-down for him personally," said Tony Sage, executive chairman of **Cape Lambert Resources Ltd.** Ms. Gillard is from the left and was never a favorite of the mining industry," he added.

Ms. Gillard made it clear soon after taking charge that she still believes miners should be paying more tax. And a senior union official—Ms. Gillard's candidacy was backed by both the party's right wing and key worker unions on the left—said that while the government may be more open to reviewing aspects of the proposal, it will press on with the tax.

Opposition Liberal leader Tony Abbott said the government has "changed the salesman, they haven't changed the product." Ms. Gillard, he said, is "committed to the same dud policies that Kevin Rudd was committed to."

Emissions trading came up at Ms. Gillard's first news conference as prime minister, where she expressed disappointment that Australia doesn't have a price on carbon. But she acknowledged her role in the Rudd government's decision to

shelve until 2013 an emissions-trading scheme that had failed to attract the support of Australia's senate, and said a "community consensus" is required before it can be introduced.

"If elected as prime minister, I will re prosecute the case for a carbon price at home and abroad," Ms. Gillard added. Under the shelved legislation, Australia would adopt a market-based trading system similar to one in Europe that caps the amount of carbon dioxide that companies may vent. To emit more, a company would have to buy "carbon permits" in the market. This "cap-and-trade" system is meant to provide a financial incentive to reduce emissions.

Emissions-trading supporter Clive Hamilton, founder of the Australia Institute, a think tank, and vice chancellor of Charles Sturt University, said Ms. Gillard's remarks concerned him, noting she didn't set out a specific strategy.

"It certainly did not suggest that the new prime minister is approaching climate change with a great deal of conviction," he said, adding that he thinks "previous efforts collapsed because the Rudd government was too keen to get consensus." Still, Mr.

Hamilton said the legislation could be revisited if Ms. Gillard wins election and the Green Party holds some measure of power.

Switching leaders is a high-stakes political strategy. This was the first ouster of a sitting prime minister since Bob Hawke was unseated by Paul Keating as Labor leader in December 1991. Labor went on to win an election under Mr. Keating in 1993.

"I think the Labor Party have made a very smart move and they made it in the nick of time," political expert and respected pollster Malcolm Mackerras said.

"She should call an election straight away while the excitement, euphoria and the honeymoon period are still strong," said Griffith University political analyst Elizabeth van Acker.

Australian National University professor Mr. McAllister said the honeymoon period is likely to last 100 days, during which Ms. Gillard will have a 3% to 5% advantage over Mr. Abbott—normally more than enough to swing the election either way, he added.

—Ross Kelly  
and Cynthia Koons in Sydney  
contributed to this article.

## Leader has labor roots, pragmatic streak

By NEIL SANDS

CANBERRA—Julia Gillard entered Australian federal politics in 1998 railing against big business and opportunism, but has since displayed a pragmatic streak that her Labor Party supporters hope will help correct the mistakes that led to the downfall of her predecessor.

Ms. Gillard, 48 years old, has always stood out in the male-dominated world of national politics and

was tipped as a future leader years before she ousted Prime Minister Kevin Rudd in an uncontested party ballot Thursday morning.

Where Mr. Rudd was seen as unable to delegate, a shortcoming that eventually cost him the support of Labor's factional chiefs, Ms. Gillard is viewed as a consensus politician who will consult with her peers.

Born in Wales—her father worked as a psychiatric nurse—Ms. Gillard came to Australia at the age

of four and grew up in Adelaide. She moved to Melbourne in her 20s and joined a law firm where she represented employees in workplace disputes.

She forged close links with the labor movement and with the union-aligned Labor Party before being elected to Parliament in 1998 to represent the gritty electorate of Lalor in Melbourne's western suburbs.

Analysts were divided on how these experiences may translate.

RBC Capital Markets economist Su-Lin Ong said Ms. Gillard's union roots make her a backer of government intervention and spending.

But Australian Council of Trade Unions Secretary Jeff Lawrence said the new prime minister is nobody's puppet. "I don't think Julia Gillard is controlled by anyone," he said. "I've known her a long time, and she's a very independent, forceful person. She will set the agenda for the government and the country."

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## WORLD NEWS

# Muslim party opens arms in Malaysia

*PAS softens tone to reach out to new voters*

By JAMES HOOKWAY

KUALA LUMPUR, Malaysia—A political party once bent on turning Malaysia into an Islamic state is for the first time preparing to put up non-Muslim candidates for election, in a bid to grab the political center in this divided country.

Some other Islamic-based political parties around the world have tried to make themselves more accessible to mainstream voters in recent years. Islam-based political parties in Indonesia have attempted to dig themselves a foothold in that country's young democracy. Turkey's Justice and Development Party has built a mass support-base that has twice elected Prime Minister Recep Tayyip Erdogan.

Now, frustrated with Malaysia's entrenched race-based government and worried about the stability of its opposition partners as speculation grows that the government may call early elections, the Pan-Malaysian Islamic Party is reaching out to its non-Muslims, who make up around 40% of Malaysia's 28 million people.

It's a big change for the party, best known by its Malay acronym PAS. Many of its top leaders prefer long billowing robes and turbans to the western-style business suits favored by top government officials.

The party's founding objective was to create an Islamic state in Malaysia, a major exporter and resources powerhouse that has long been regarded in the Muslim world as a home to a modern, moderate form of Islam.

Alex Ong, an investment banker for 20 years who now works for an organization helping migrant workers, set up PAS's non-Muslim "supporters' club" in 2004.

The 51-year-old Baptist says the party represents Malaysia's best chance of breaking its race-based political system and eliminating graft from a country that's ranked worse than South Africa, Jordan and Uruguay by Berlin-based watchdog Transparency International.

"PAS is the most misunderstood political party in Malaysia," says Mr. Ong. He says the party's turban-wearing leaders aren't really focused on turning Malaysia into an Islamic state, and notes that the PAS hierarchy has no problem with him eating pork or drinking alcohol.

Instead, Mr. Ong says, "we want to encourage Islamic values to help strengthen the state and push for a moral renewal."

Some PAS members, however, are cautious of alienating their predominantly ethnic Malay support base, and suggest overtures to non-Muslims could be easily reversed.



Agence France-Presse/Getty Images

Non-Muslims, such as Hindus taking part in a festival in January, above, make up 40% of Malaysia's 28 million people.

Many urban non-Muslim voters, too, are wary of PAS and its mostly rural roots, especially as the country has taken a steadily more Islamic direction in recent years. This year for the first time, three Muslim women were caned for engaging in extramarital sex, while the government is appealing a court ruling allowing Christians to use the word "Allah" as a translation for "God" in Malay-language publications.

But some political analysts say PAS's outreach could help alter the political landscape in this ethnically diverse, resource-rich nation. Since independence from Britain in 1957, Malaysia has been governed by the

National Front, an amalgamation of ethnic Malay, Chinese and Indian-based parties whose affirmative-action policies have impeded economic growth in recent years, economists say, undermining Malaysia's role as a development model for the Muslim world.

A growing number of voters have turned to a PAS-backed opposition alliance, which broke the National Front's two-thirds majority in Parliament in 2008 for the first time in decades and has since won eight of 11 special elections. Prime Minister Najib Razak has to call a new election by the middle of 2013.

PAS's move to bring in non-Muslim

candidates, announced at its annual conference on June 11, appears designed to expand the party's electability. To that end, its leaders discuss defeating corruption as frequently as they talk about strengthening traditional Muslim values. PAS's vice-president, Nasaruddin Mat Isa, says it expects to field its first non-Muslim candidate "soon."

"PAS is trying to show non-Muslims that they can engage with them, and they are being quite bold in this," says Bridget Welsh, a political science professor and Malaysia expert at Singapore Management University. "There's no question PAS now has national aspirations."

## Group prohibits some Zimbabwe diamonds

The ban on diamond exports from a controversial field in Zimbabwe will remain in place for now, a top Kimberley Process official said Thursday, after four days of negotiations at a meeting in Tel Aviv failed to reach a final decision.

By Sarah Childress in Nairobi, Kenya and Sara Toth Stub in Tel Aviv

"There have been good faith and repeated attempts to come to compromise," said Stéphane Chardon, the Kimberley Process's chairman of the working group on monitoring. "It just didn't come to an agreement."

Mr. Chardon said the Kimberley Process would consider the issue at future meetings.

The next step is for the "main stakeholders" to reconvene on the issue in St. Petersburg in July at the annual meeting of the World Diamond Council, said Boaz Hirsch, chairman of the Kimberley Process.

Mr. Hirsch said he hopes the group will find a way to get diamonds from Zimbabwe's Marange field back on the market.

In a few weeks, the Kimberley Process will send a mission to Marange, Mr. Hirsch said, to conduct a compliance review scheduled before the Tel Aviv meeting.

The protracted discussions on whether to allow diamond exports from the controversial field have exposed deep fissures within the Kimberley Process, turning the meeting into a referendum on the viability of the group as a global monitor for the stones.

Members of the Kimberley Process Certification Scheme—nations, watchdog groups and industry representatives—gathered this week in Tel Aviv in an attempt to persuade Zimbabwe to comply with Kimberley regulations.

Zimbabwe has been under investigation for allowing the military to control the Marange diamond field, as well as permitting diamond smuggling and illegal panners—mostly local people hoping to strike it rich in the unregulated area. In November, the Kimberley Process suspended sales of Marange diamonds until improvements could be made.

On Wednesday, as negotiations dragged into the night, Zimbabwe threatened to resume sales of the diamonds with or without Kimberley approval, participants said. Member countries are prohibited from purchasing uncertified diamonds. The group's meeting followed a recent report from a Kimberley investigator, South African Abbey Chikane, who recommended the diamonds be authorized for sale after noting the "hard work" that the government had put into improving conditions in Marange. Human-rights groups, meanwhile, reported little change on the ground.

In Tel Aviv, a rift opened between Kimberley participants who don't support sales of the Marange diamonds, such as the U.S., Canada, and the watchdog groups; and others, including India, Russia and several African nations, who want to follow the report's recommendation and allow sales to resume, according to people in the meeting.



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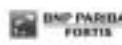
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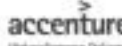
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